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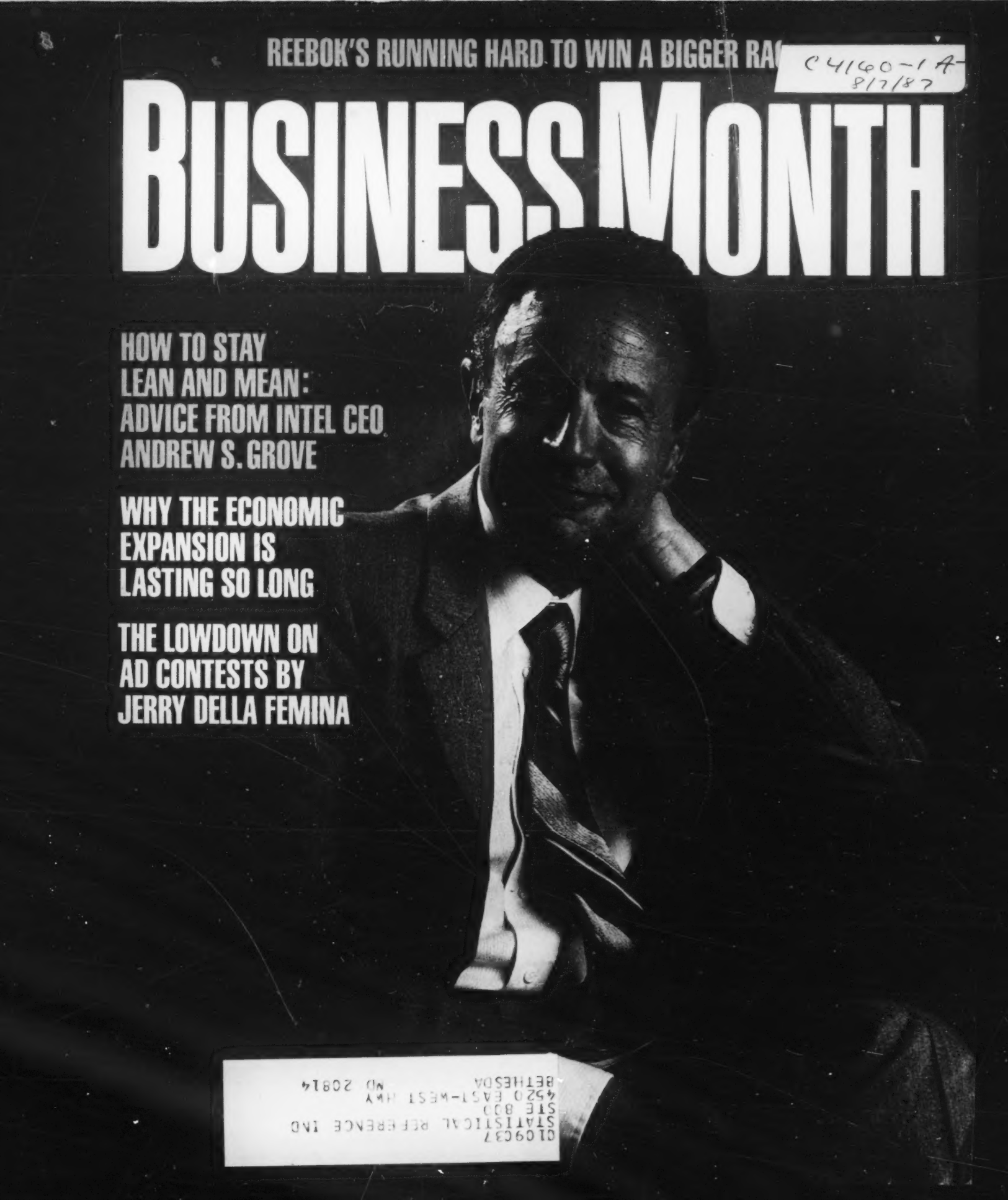
# BUSINESS MONTH



HOW TO STAY LEAN AND MEAN: ADVICE FROM INTEL CEO ANDREW S. GROVE

WHY THE ECONOMIC EXPANSION IS LASTING SO LONG

THE LOWDOWN ON AD CONTESTS BY JERRY DELLA FEMINA

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# BUSINESS MONTH

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COVER PHOTOGRAPH BY BRITAIN HILL

# What Keeps the Expansion Going?

*Five years of putt-putt prosperity have been driven by a combination of forces we are only beginning to understand.*

*by David Fairlamb and Edward Mervosh*

Shouldn't we be celebrating? After all, the inflation-free global expansion is nearing its fifth birthday. By summer's end it will be the longest peacetime economic upswing ever, and apparently there is more to come. "Unless the economists have got it hopelessly wrong, the world is well on the way to its first six-year or seven-year period of sustained economic growth," predicts Carlo Sartor, head of the Brussels-headquartered Confederation of European Industry.

Yet few economists, politicians or business folk are uncorking the champagne. The worldwide expansion may be the most durable on record, and has helped send global securities markets to all-time highs, but it is also one of the weakest. Sustained disinflation has replaced the hyperinflation of the Seventies. In the bargain, five-year gross national product growth of the 24 member nations of the Organization for Economic Cooperation & Development has chugged along at only 2.5% a year, and may drop to 2.25% for 1987. U.S. growth is expected to wind up at around 2.5% for this year. The West German and Japanese economies are inching forward even more slowly.

"There's not very much for us to drink to," complains Dr. Martin Croft, a business-cycle specialist at Britain's Cambridge Economics Group. Except that we have now enjoyed almost five years of economic stability. Except that runaway inflation is no longer depleting our wealth and sapping our initiative. Except that Americans are now working and earning and spending on a scale never seen before.

Could it be that today's complainers are simply greedy folks who can't stand well-modulated, inflation-free prosperity? Or is it that economists and business executives do not have the perspective to understand the combination of forces that produced today's disinflation and finally broke the numbing string of nine boom-to-bust postwar cycles? These forces are:

☐ The swift integration of the U.S. into the global economy during the Eighties.

☐ The conflicting, uncharacteristically cautious economic policies of the three most powerful industrial nations—Germany, Japan and the U.S.

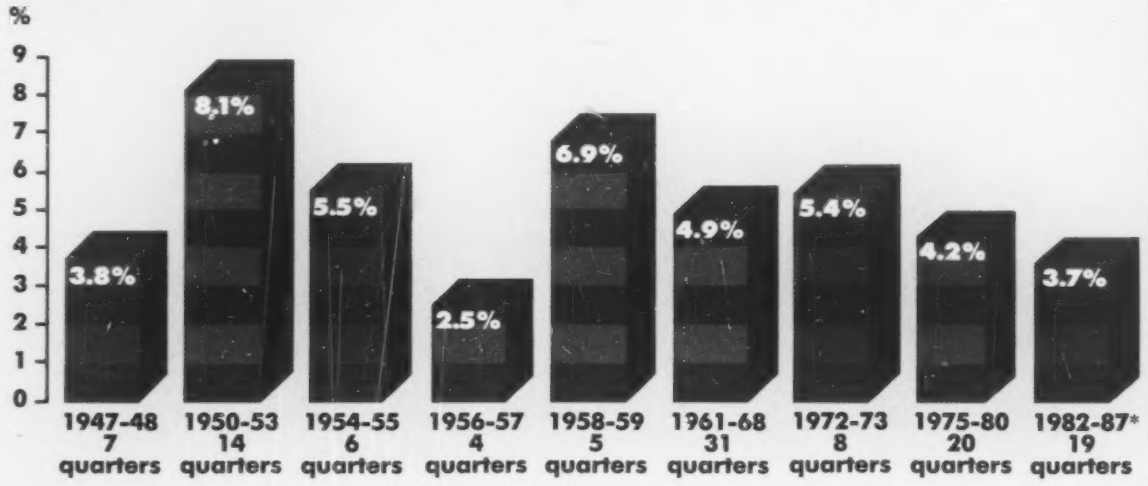
☐ Concomitant major changes within key economic sectors—including accelerated restructurings in maturing smokestack industries, jarring shakeouts in the agricultural and energy sectors, and the mushrooming significance of the service industries.

Powerful as they are, these forces have not eliminated economic ups and downs. Cycles remain one of the unhappy inevitabilities of modern industrial life. These forces have, however, ushered in a prolonged period of noninflationary growth that differs from any-

ILLUSTRATION BY RON RIDGEWAY

## THE CURRENT EXPANSION: HOW WEAK IT IS

Yes, it has been long, but economic growth is the second-slowest of any since World War II.




Annual average growth in gross national product in 1982 dollars. *Includes estimate for second quarter 1987.
Source: Wharton Econometrics Inc.

thing today's generation of business executives and economists expected or are prepared to accept as desirable. We had learned to "stand" the kind of prosperity that fueled rapid inflation and then ran out of gas. What we have now is a putt-putt prosperity that is trying everyone's patience, not to mention nerves. Let us consider the forces at work.

### JOINING THE WORLD ECONOMY

Nobel laureate Paul A. Samuelson describes the global integration of the U.S. economy this way: "For much of its history the U.S. was a continental, semi-autonomous economy. But around 1960 we joined the rest of the human race, and we haven't yet been able to find a way to resign."

Not until the Eighties, however, did the interdependence of the U.S. and world economies become a harsh reality for the majority of American businessmen. The U.S. economy still accounts for more than 50% of the output of the OECD countries, and still sets the growth pace for the rest of the world—expanding faster than any of the other G-7 economies from 1983 to 1986 *(see table)*. But today high-speed communications, transportation and greater access to foreign markets have made the world marketplace a two-way street for Americans—with U.S. imports jumping from 10% to 14% of the GNP since 1976 while exports rose from 9% plus to more than 10%.

"The U.S. is at the center of an increasing internationalization of the world economy," declares Geoffrey Moore, Columbia University's highly respected business-cycle guru. "Deregulation of the financial markets, especially, has speeded up the process."

> ***"The growing importance of the service industries adds two-to-three months to expansions and cuts recessions two-to-three months"***
>
> **—Geoffrey Moore**
> **Columbia University**

Offsetting the obvious pluses of growing global integration—like opening up new markets for American goods—are its growth-dampening effects on the U.S. economy. As the American appetite for imported goods has grown, domestic output and employment have suffered. At the same time, more and more U.S. companies find themselves depending on fiercely competitive foreign markets for growth and profits.

The superstrong U.S. dollar of the early Eighties made it cheap for Americans to buy foreign goods and tough for U.S. exporters to sell abroad. The result: the largest trade shortfalls in U.S. history. President Lawrence Chimerine of Wharton Econometrics says, "The superdollar in the first half of the Eighties was an enormous economic shock that helped slow the expansion by intensifying foreign competition." Wharton estimates that trade deficits between 1983 and 1986 shaved nine percentage points from U.S. GNP growth and cost some two million American jobs.

Trade deficits, however, have not been all bad for the U.S. Greater foreign competition has also helped keep U.S. inflation under control. Explains

CHARTS BY NINA WALLACE

David Hale, chief economist for Kemper Financial Services: "Because U.S. consumers could buy foreign goods cheaply, heavy domestic demand has not produced the bottlenecks in U.S. production that in past expansions generated excessive inflation and eventually cut the expansions short." Adds Paul Samuelson, "The open U.S. economy has acted as an inflation safety valve." The price: slow growth.

**POLICIES AT CROSS-PURPOSES**

Without question, the increasing integration of the world economy has reduced the impact of U.S. economic policy, both at home and abroad. And this too has had a dampening effect.

Gone are the days when the U.S. was the main locomotive and could push and pull the rest of the world economy at will. Vivid evidence of the change is Treasury Secretary James Baker III's dogged crusade for greater coordination of economic policies—particularly his intense pressuring of Japan and West Germany to adopt more stimulative policies. Washington can no longer determine the outcome through its own policies alone; today it needs help.

During the current expansion, the fiscal (as opposed to monetary) policies of the Big Three have often worked at cross-purposes. At the same time the U.S. was cutting taxes and running up huge budget deficits, economically conservative governments in Europe and Japan were following very restrictive budgetary programs designed to prevent a rekindling of inflation.

Budget deficits in West Germany and Japan fell from 3.5% of GNP in 1982 to just 1% last year, according to DRI. Both governments, remembering the cruel inflation of the 1970s, have been reluctant to underwrite growth through tax cuts and spending increases.

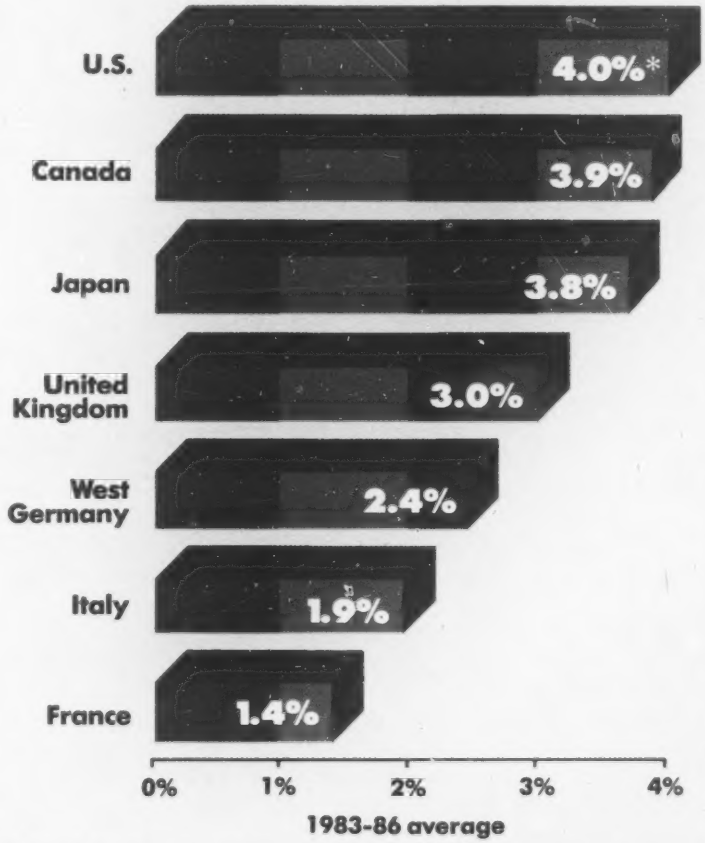
With Japan's GNP growth flagging badly for a second straight year, however, Tokyo recently announced plans to inject $42 billion into its economy. But the Germans are still holding back. Politicians in Bonn remember the last time Germany attempted to boost the economy with modest tax cuts—in 1978, just before the Iran oil shock of 1979 ran inflation into double digits throughout the industrialized world. West Germany's own inflation, exaggerated by the untimely tax cuts as well oil dependency, led directly to a traumatic current account deficit, a crumbling Deutschemark, a deep recession and, eventually, the downfall of Helmut Schmidt's government.

The growth-cramping fiscal policies in Europe and Japan have contrasted sharply with Washington's tax-cutting and lavish budget shortfalls. The U.S. budget deficit rose from 4.5% of GNP in 1982 to as high as 6.5% and still stands around 5% today. But much of the stimulative impact on the U.S. economy was diverted into American buying of a rising tide of imports from across the oceans. Thus, the Reagan Administration and U.S. Congress gave the European and Japanese economies a big lift that they weren't getting from their own governments.

"West Germany and Japan could not have cut their budget deficits so much without the global stimulus of the big U.S. budget deficits," explains Roger Brinner, senior vice president for DRI. "They got a free ride that cost this country between $50 billion and $90 billion on the trade accounts by 1986."

## THE U.S. ECONOMY: THE GROWTH LEADER

Despite the country's mammoth budget and trade deficits, the growth rate of the U.S. economy has led the industrialized world.




Annual average increase in gross domestic product in 1982 dollars. Source: Wharton Econometrics Inc.

Had other major nations followed the U.S. policy line, worldwide economic growth would have been much stronger; because they didn't, growth has been much more modest but also less inflationary.

What kept Washington's spendthrift fiscal policy from spurring an economic boom was Federal Reserve Board Chairman Paul Volcker's passion for controlling inflation. His tough monetary policy starting in 1979 had broken the runaway inflation of the late 1970s and early 1980s. Then, his focus shifted to reviving growth without fostering a boom. "Early in the decade the Fed took responsibility for dampening inflation and pushing the economy into recession," explains Columbia's Geoffrey Moore. "Since then it has provided just enough money to keep the economy going. If the Fed had wanted a boom, it could have pumped out enough money to get one, but it didn't."

Abroad, West German and Japanese central bankers have stayed in step with Volcker's monetary policy in the past couple of years. Big U.S. trade deficits and the superstrong dollar forced them to cooperate. Fear that steadily growing U.S. deficits would prompt Congress to erect trade barriers, for example, was the major reason that Secretary Baker could persuade the G-5 countries at their first meeting in 1985 to knock down the dollar. What followed were coordinated efforts by the central banks of the U.S., Japan and West Germany to bring interest rates into better balance and lower the dollar substantially. The ultimate effect, only recently evident, was to begin lowering the U.S. trade deficit—and to add months, or even years, to the current economic upswing.

### MICROECONOMIC SIDE EFFECTS

If the slow-growth, low-inflation expansion sounds smooth and almost boring, perish the thought. It has been marked by unprecedented booms in some sectors (notably technology and financial services), busts in others (energy and agriculture), and sweeping restructurings in maturing basic industries (autos, metals, chemicals) that have been more revolutionary than evolutionary. "Examine the statistics in detail, and it's clear that this is the patchiest upswing ever," says Robin Marshall, chief economist at Chase Manhattan Ltd., the London subsidiary of the U.S. banking giant. "At the same time, many industries are following their own unique business cycles, which often as not don't reflect the performance of the economy as a whole. It's as if the economy had taken on a dual personality," he adds.

Other contradictions illustrate the seemingly schizophrenic behavior of the industrialized economies in the Eighties: nations achieving only modest increases in output despite substantial productivity improvements; industries shedding labor while others are unable to find enough skilled workers; record new business start-ups uncannily juxtaposed with a continued high level of corporate bankruptcies.

The sea change from the hyperinflation of the 1970s to the disinflationary environment of the 1980s is probably the biggest single reason for the turbulence within individual industries and the apparently contradictory trends. This historic shift in the world's economic direction was engineered by the tightfisted policies of the Volcker Fed and the German and Japanese central banks, which plunged the world economy into the 1981-82 recession and drove weak industries and companies up against the wall.

Not all industries were affected in the same way or at the same time. Sectors that benefited from the high inflation (including energy and real estate), or had built up substantial inflation hedges on the assumption that high inflation would last well into the Eighties, got clobbered. This explains why U.S. banks, heavy in energy and real estate loans, suffered a rash of insolvencies in the early part of the recovery and are still writing down problem loans by the billions. Also hurt were the mining, agricultural and smokestack industries, which were hard-pressed to service heavy debt and make much-needed capital improve-

## PRESIDENTS' PANEL: CEO'S WORRY ABOUT INFLATION, NOT RECESSION

With the economic expansion about to break the peacetime record of 58 months, set back in 1975–80, you would expect to find business executives worried about a slump. But not the top executives on the BUSINESS MONTH Presidents' Panel. Our latest quarterly survey of CEOs at 200 of the largest U.S. corporations shows that America's business leaders fear renewed inflation far more than a slowdown or a recession.

By their own admission, however, business executives are also part of the inflation problem. Quite a few panelists report that because suppliers have raised prices, they in turn have raised their own selling prices to reflect the cost increases. In many instances, panel members say, the depressed dollar is the culprit, pushing up the cost of imported raw materials and supplies for U.S. producers.

"We have modestly increased the price of many of our products due to higher raw material and labor costs," says Martin Davis, president of Gulf & Western, in a typical response to our latest survey. "Higher oil prices and a weaker dollar," says Thomas Russell, president of Federal Mogul, are pushing up the costs of what the company buys. "Our raw materials such as copper, tin, steel, teflon—all world-price items are rising," he notes.

Other CEOs report that some U.S. companies, even without the justification of cost increases, are taking advantage of a price umbrella provided by foreign competitors to fatten profit margins through price hikes. With the weak dollar forcing foreign competitors to raise prices, explains

President J. C. Cotting of Navistar, "some U.S. manufacturers are taking advantage of the situation to raise prices instead of increasing U.S. competitiveness."

Price hikes are possible too, CEOs note, as the general economic environment is riper. "We have found no resistance in the marketplace to price increases," says Gulf & Western's Davis.

But if business is good, it is not great. That's the consensus across industry lines. It is also the climate most of the CEOs expect for their businesses and the economy over the balance of this year and in 1988. Almost all see the expansion continuing, not sinking into recession. But most forecast continued growth at the same sluggish pace of the past couple years. Says the CEO of one diversified company: "The improvement in the trade balance will prop up the industrial economy."

A handful, however, does look for next year to be much better than 1987, at least in their particular industries. This is the view of Federal Mogul's Russell. "Fifty percent of our business is in the automotive aftermarket, which will see an upturn in 1988 due to an increase in the number of vehicles in the six-to-ten year category, including the Japanese models," he explains. "We see improved demand for trucks because of the growth in industrial production," predicts Navistar's Cotting.

"Scott Paper's outlook for next year is strong," says company President P. E. Lippencott. Like many other forest products outfits, he says, Scott will begin to reap the benefits of recently completed capital investment projects that have aimed at cutting costs even as they boost the volume of production.

None of the Panel members expects a recession this year. "We believe recession, which is two consecutive quarters of negative growth, is unlikely," predicts Lippencott. "Recessions normally follow a period of high inflation and high growth. They are a reaction to an overheated economy. This hasn't happened." Adds Federal Mogul's Russell: "A recession is politically not acceptable the year before a presidential election."

But most executives would rather face the possibility of recession than operate in an economic expansion kept alive by rising government spending or by slashing interest rates. Says one top executive: "Any attempt to head off a recession by beefing up government spending will be very foolish with the revenue and deficit problem out of hand. The idea that we can have a permanent booming economy occurs only in fairy tales and congressional campaigns."

Almost all of the respondents rated President Reagan's overall economic performance as "good." The majority credit Reagan with getting inflation under control. They feel the President has kept the economy growing, furthered deregulation and cut taxes. But an equally large number believe Reagan has done a poor job in controlling government spending and shrinking the budget deficit. Sums up one CEO: "The President's greatest economic failure is the inability to fashion a working arrangement with Congress on a reasonable basis and to control spending."

Tax reform gets mixed reviews. Most executives say that it has not hurt their overall business, but it has made them reluctant to invest in new plant and equipment. "Loss of investment tax credits, the stretch-out of depreciation lives, and the partial loss of interest deductibility work to raise the cost of capital and lower investment returns," argues the president of a large oil company. Adds Scott Paper's Lippencott: "As the new law continues to phase in during 1987 and 1988, our tax rate will decline from 46% to 34%, but this decline will not fully compensate for the loss of the investment tax credit and the increase in the capital-gains tax."

Restoring incentives for capital formation such as the ITC or lower capital-gains taxes would, of course, cost the Treasury billions in lost tax revenues. BUSINESS MONTH asked executives what kind of tax increases would be acceptable to make up for the revenue lost if capital spending incentives were restored. Surprisingly, most executives supported a value-added tax, an idea that has received only scant attention in Washington in the past. "A value-added tax would retain [investment] incentives and solve the [revenue] problem," says Duane R. Kullberg, CEO of Arthur Andersen & Co. Federal Mogul's Russell agrees: "A VAT tax is a better method of collecting the cost of government to the general public, and it leaves profits to be used in capital formation."

In general, CEOs favor raising consumption taxes rather than personal income taxes. A tax on imported oil was the second-most-favored means of raising revenues to replace those lost if capital incentives were restored. "A consumption-type tax should provide the revenues for restoring incentives for capital formation," says the president of a major oil company. CEOs, however, don't appear anxious to mount a campaign to restore capital investment incentives. Most go along with the view of Navistar's Cotting, who doesn't "favor near-term changes in the tax law." —E.M.

ments in the fiercely competitive, slow-growth environment that followed the recession.

Unlike previous business cycles, disinflation this time is clearly a long-term phenomenon. In Japan, West Germany and other industrialized countries, prices have not risen at all so far this year. The notable exception is the U.S., where the rate of inflation is expected to rise from 2.1% in 1986 to 4% this year. But it is not likely to rise much higher, says the forecasting consensus. In fact, some seers believe U.S. inflation will drop back to an average 3% for the rest of 1987.

Battered by the slow-growth environment, as well as by technological obsolesence and rising competition from developing nations, the industrial dinosaurs of the U.S. and the rest of the OECD have been forced to replace their old capital stock with new high-tech equipment. In some industries—most noticeably the smokestack sector—the process has been accompanied by massive reorganizations of product lines and balance sheets. This has often reduced output and made companies much smaller, but also more efficient and profitable.

From autos and steel to chemicals and forest products, aging companies once headed for the graveyard have begun to revive themselves. Some won't make it in the end, but many will.

Less alert companies and those in the most deeply troubled industries have needed more time to restructure. That is why it has taken almost five years for some traditionally cyclical industries to begin to enjoy the economic upcycle, and why the expansion has such a Jekyll-and-Hyde look—with some prospering and others going broke. It is also one more reason for the slow pace and stretched-out duration of the recovery.

Still another expansion-prolonging force is the long, gradual rise of the service sector in the U.S. and global economies. Explains Columbia's Moore: "Growth in the service industries doesn't decline as it does in manufacturing; it only slows down. That is partly because service industries, with the exception of retailing, don't build up inventories. The growing importance of the service industries in the U.S. economy adds about two-to-three months to expansions and cuts recessions by two-to-three months."

***"If Japan and Germany don't grow fast enough, the U.S. expansion could be in deep trouble"***

**—David Hale**
**Kemper Financial Services**

DRI's Brinner also believes that scattershot government policies in the U.S. and abroad has added to the sectoral turbulence and helped keep world economic growth low in the Eighties. "This expansion has not been a continuous flow, but a series of small economic waves," he says, from the early Reagan tax cuts and the Gramm-Rudman-Hollings budget-cutting act in the U.S. to the Yamani-inspired oil price war and the restrictive budget policies in West Germany and Japan. "It is as if the governments were sitting in a big bathtub and making a splash and just watching the waves," Brinner adds. "It's just luck that these radical policy shifts, which often worked in opposite directions, seemed to cancel each other out and that the U.S. has been able to sustain even 2.5% growth."

Most economists believe that the present sluggish expansion is the best scenario anyone could hope for at this time. Looking on the bright side, they say that as there is little chance of industrialized economies overheating, inflation can be kept firmly under control and the recovery sustained far longer than would otherwise be the case. Says Tomohisa Niimi, a business-cycle specialist at Japan's University of Kyoto: "Because the U.S. and other economies are growing so modestly, it is only natural that it will take longer to run into the capacity constraints and inflationary pressures that generally herald the approach of a downswing."

On the downside, continued slow growth—even if inflation-free—will not be enough to cut record-high unemployment in Europe, to correct the huge U.S. payments imbalances or to solve the Third World's towering debt problems. Economists and bankers are also edgy about the mountains of consumer and corporate debt built up in the U.S. during the current expansion. Some worry that this could presage an inflationary outburst like that of the Seventies. Others fear that there is no way the debt can be paid off in a slow-growth world economy.

Still others worry that the huge increase in stock and bond market values since 1982 is not backed by solid economic growth. "Every major stock market in the world has been pushed to all-time highs by the enormous creation of money and credit in recent years," says Paul Samuelson. "It will be a miracle if Tokyo, or even London or New York, doesn't get hit with a bad break in stock prices."

Other economists fret that consumer spending is now tailing off in Europe and the U.S., that capital investment is weak worldwide, that the U.S. government is in no position to stimulate greater growth because of its huge budget deficits. There are concerns too that the lower, but stabilizing, dollar may not boost U.S. exports and growth by very much. "If the other two locomotives [Japan and West Germany] don't grow fast enough, the trade deficit will not shrink quickly enough, and the U.S. expansion could be in deep trouble," maintains Kemper's David Hale.

Small wonder, then, that few business executives are uncorking the bubbly as the global expansion approaches its fifth anniversary. Yet this much is worth celebrating: The industrialized world is much better off than it was ten years ago when OPEC was calling the tune and inflation was raging out of control.

Cheers. ■

## "Tell Me Where The Jobs Are . . ."

Today's job market is changing fast. It can be tough to keep track of where job opportunities with a future are opening up. Whether you're a graduating high school student, a former career woman facing the challenges of re-entry in the job market, or a member of the work force discovering the need for new skills to get a promotion, choosing a career direction is never easy.

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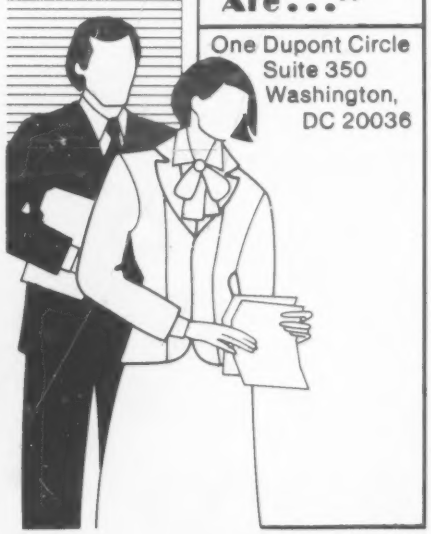


## INVESTMENT UPDATE

**Here's the current status of a number of investments, and a look at how they have fared over the past month and the past year.**

| INVESTMENT | (6/30/87) Recent Price or Yield | Value of $10,000 if invested: Month Earlier | Year Earlier |
|---|---|---|---|
| **Common Stock** (Index fund, capital gains and dividends reinvested) | $30.50/share | $10,502 | $12,464 |
| **per cent change** | | +5.0% | +24.6% |
| **Bonds** (30-yr., 11¾% Treasury Bond) | | | |
| MARKET VALUE | $125.50 | $ 9,975 | $ 9,194 |
| ACCUMULATED INCOME | | $ 78 | $ 861 |
| TOTAL | | $10,053 | $10,055 |
| **per cent change** | | +.5% | +.6% |
| **Money Market Fund** | 6.01% | $10,049 | $10,569 |
| **per cent change** | | +.5% | +5.7% |
| **Gold** (Krugerrands) | $453.80/oz. | $ 9,985 | $13,040 |
| **per cent change** | | -.2% | +30.4% |
| **HOUSE PRICES** | **Recent** | **Month Earlier** | **Year Earlier** |
| **Existing House** | $115,000 | $120,000 | $108,500 |
| **per cent change** | | -4.2% | +6.0% |
| **New House** | $129,500 | $132,900 | $122,100 |
| **per cent change** | | -2.6% | +6.1% |

Sources: Vanguard Group Inc.; Salomon Brothers; Donoghue's Money Fund Report; Manfra, Tordella & Brookes, Inc.; Federal Home Loan Bank Board.

all-time highs, Straus is buying—in the belief that they can double within three years.

His favorite is LIN Broadcasting, a cellular franchise that also owns network television affiliates. The lack of cellular purity in LIN's case is offset by the fact that its TV activities are generating the cash flow to fund its cellular growth. LIN has teamed up with Metromedia and may one day buy out its partner's cellular franchises. But Straus also likes Affiliated Publications, which owns the *Boston Globe* as well as cellular operations.

His choicest pure plays are Cellular Communications and Metro Mobile CTS, both of which are losing money now but could, Straus believes, report earnings as early as 1988. American Cellular Network Corp. is another intriguing company that has a New Jersey franchise, including the heavily traveled corridor surrounding New York City. To carry on a conversation on a car telephone while driving through New Jersey, the caller must use American Cellular's service.

As for basic industry cyclicals, Straus likes the aluminums best. "Aluminum is in the same position as paper stocks were last year," he says, with productive capacity and inventories cut to the bone. Straus believes the weaker dollar and an improving U.S. economy can lift aluminum prices from around 70 cents to at least 80 cents a pound. This, in turn, could boost shares of Reynolds Metals and AMAX by 50% and Alcoa by perhaps 30%.

Straus is also starting to buy financial stocks after avoiding the sector for the past year; a large correction and low relative multiples have won him over. His top pick: the newly traded shares of Shearson Lehman Brothers, which he calls "the best large brokerage firm" due to its good mix of retail and institutional businesses. He is also buying bank stocks, encouraged by their Third World loan write-offs. His main choices: Republic National Bank of New York, Citicorp and J.P. Morgan & Co. He's looking for a 25% move in bank shares during the next six months. —LEAH NATHANS